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The Financial Crisis Celebrates its First Birthday
Where Are We?

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Thank you for the opportunity to address this distinguished group. The views expressed in this talk are my personal opinions and not necessarily those of Webster Bank or Webster Business Credit. These opinions are subject to change without notice.

► How did we get here? A brief review:

Some say the origins of our current situation began after 2001 when interest rates were driven to exceedingly low levels and stayed there for too long, opening and keeping open the spigots of easy credit. And “Asset Backed Securities”, are also blamed for the mess in which we find ourselves, although they gained prominence in the mid 1990s. However, around 2005 credit derivatives such as “Credit Default Swaps”, replaced credit insurance as the preferred alternative for credit enhancement of asset backed securities. And unlike traditional bond insurance, the underlying debt issuer is not involved in the credit default swap transaction. As a result, the market for credit derivatives grew to be larger than the market for the underlying assets themselves. It is estimated that credit derivatives now exceed \$50 trillion.

Structured Investment Vehicles (SIV's) such as Collateral Debt Obligations, a type of asset backed security backed by pools of diversified debt instruments, continued to gain popularity with fund managers, particularly those with sub-prime loans and home equity lines of credit (HELOCs). Collateral Debt Obligations or CDO's accepted riskier loans in securitizations that bond insurers and traditional investors would reject. In so doing, the benefit to the market provided by these groups, that is, the limit on the riskiness of loans that originators could securitize went away. The result was that the trend through 2006 was that of deteriorating sub-prime loan quality and the beginning of defaulting subprime mortgages.

The easing of credit standards through 2007 allowed financial institutions to maintain liquidity by securitizing CDO's and thereby continue lending, particularly to support the private equity, hedge fund and leveraged loan markets with loans that had little in the way of covenants; often referred to as “Covenant Lite” loans. When several large mortgage companies filed for bankruptcy citing sub-prime issues, credit agencies took notice and in July 2007 began to downgrade certain mortgage backed securities. Since the pricing of these securities was based on the strong ratings given to them by the credit rating agencies, to that just below US Treasuries, the market for the downgraded securities disappeared and trading virtually stopped as demand and values dropped.

The impact began to be felt by lending financial institutions including commercial banks, investment banks and private equity firms. When securities these institutions held could

not be sold, and remained on the books of the underwriting organizations, liquidity in the market evaporated. This event has been referred to by some as a “Black Swan” event, representing an extremely rare occurrence as seeing a black swan may happen only once or twice in one’s lifetime. Under normal circumstances, it is the smaller weaker credits that are affected first. However, in the current financial crisis, the opposite occurred as the ability to finance the largest size transactions in the upper market (companies with sales in excess of \$1 billion) ceased, while financing to middle market companies (with sales from \$20 million to \$1 billion) continued, albeit at a slower pace. Pricing also reversed, being higher for large syndicated loans than that of the smaller loans, which were being held and kept on the books of a single institution, or a small group of 2 or 3 lenders, sometimes referred to as a “Club”.

The credit crunch, that is the lack of liquidity in the capital markets, continues as financial institutions of all sizes now concentrate on raising enough capital to maintain balance sheets with tangible net worth, reasonable leverage and, to stay in business. To gain some perspective, allow me to offer some statistics, thanks to Arthur D. Little, Standard & Poor’s and Allied Capital. Senior loan volume to middle market companies went from almost \$200 billion in the 2nd quarter of 2007 to just over \$40 billion in the 1st quarter of 2008. The senior loan pipeline went from \$235 billion in 2007 to an estimated \$70 billion in the 2nd quarter of ’08. And, of course, this includes transactions that were in the pipeline in ’07 prior to the summer credit seizure. With the liquidity freeze, private equity firms were unable to obtain the leveraged financing necessary to complete acquisitions. Senior bank debt in the 1st quarter of 2008 represented only 36% of leveraged buyout financing compared to 60% in 2007 and 2nd tier mezzanine debt took up 19% of the financing, up from 5% in ’07. Covenant Lite term loans went from \$97 Billion in 2007 to \$0 in the 1st quarter of 2008.

► Why no defaults until now?

Until the first quarter of this year there have been few defaults, which, when one looked at the statistics, in my view, gave a false impression of the state of wellness in credit circles. Standard & Poor’s reported that institutional loan default rates, based on a lagging 12 month index, ranged from 1% to 2% between 2004 and 2006 and less than 1% for most of 2007 and through the 1st quarter of 2008.

In previous cycles, lenders, particularly commercial banks had substantial work out departments so that when a loan defaulted, it would be transferred to its work out department. In this cycle, most banks eliminated their work out units. It may be circular reasoning, but they didn’t need them because there were so few defaults, and more importantly, the banks had plenty of buyers for their weaker credits. Private equity firms, in conjunction with turnaround management organizations were aggressively competing for loans that banks didn’t want. Thus, a bank only had to put the word out that a loan was available and a buyer or buyers would surface to take out the bank, generally at full value. In the event the bank had to take a “haircut”, the loss went against reserves for bad debts thereby precluding calling a default.

Another factor was the concept of Covenant Lite, mentioned earlier. With no covenants, there would be no default triggers. Thus the early warning system that covenants offer

was not there. In addition, particularly with respect to loans related to private equity transactions, a “toggle” feature called PIK, which stands for Payment In Kind was very prominent. What this feature does is to allow the borrower to pay interest due in the form of additional debt at the maturity of the loan, rather than in cash on the payment due date. Thus with an option to “toggle” between cash and additional debt, defaults during the term of the loan are precluded.

An additional factor was the willingness of private equity funds to provide additional investment dollars when their portfolio companies needed cash. Now however, with many funds closed or nearing completion of the fund’s investments the cash is simply not available to bail out a problem company. Also, with firms financed through “fundless” sponsors, the money and willingness of investors to further invest in a deteriorating situation has vanished. While plenty of money is still around, the flavor of the day is distressed investment funds. And I suspect, these bottom fishers will wait to extract the terms they require. Here come the defaults.

Based on loss estimates that I will come to shortly, the institutional loan default rate is conservatively being projected to approach 5%. Other forecasters are suggesting default rates approaching 10%. Not a pretty picture.

► Expanding Credit Turmoil and the Effects on the Economy

In my view, the credit crisis has only recently begun to trigger a deluge of negative consequences. Many experts both in the private sector and the federal government thought and acted on the belief that the crisis of last summer was limited to sub-prime residential mortgages and there would be little effect on the overall economy from the housing slump, which was to have ended in short order. WRONG! The problem of excess and loose credit involves much more than residential subprime mortgages.

As the Financial Times recently reported, the IMF while acknowledging that policy interventions – mostly by the US Treasury and the Federal Reserve had so far succeeded in containing systemic risk, further intervention will be necessary to preserve financial stability. And as NYU Professor Nouriel Roubini said in a recent interview with Barron’s Magazine, “near prime, prime, commercial real estate, credit cards, auto loans, student loans, home-equity loans, leveraged loans, muni bonds, corporate loans-you name it” are affected. The International Monetary Fund (“IMF”) effectively confirmed this assessment when the Financial Times reported two weeks ago that “Global financial markets are fragile and indicators of systemic risk remain “elevated” almost a year into the credit crisis.” The IMF warned that credit growth in the US could fall further as a result of ongoing financial system stress and said that credit quality “across many loan classes has begun to deteriorate with declining house prices and slowing economic growth.”

Let’s look at the consumer sector of the economy: For a few years now, economists have been saying that the economy remains strong because it is consumer driven. Unfortunately, that engine has now conked out in more ways than one. With the slump in housing, and home prices being down some 15% during the past year according to the Case-Shiller Home Price Index, the “safety valve” of tapping into one’s home equity

to pay off credit card debt is gone. Credit card debt, in my view is out of control. Also, given the high rates and fees associated with credit cards, the ability of the average consumer to pay off his or her debt is slim. This issue has yet to hit the front pages. Look out.

And, with gas around \$4.00 a gallon, consumers are feeling a real impact in their wallet. While oil is down from a peak of \$140 per barrel, it is still well in excess of \$100 a barrel. Again, a few years ago when oil was \$50 a barrel, economists were saying not to worry, since oil would have to go to \$100 a barrel before we have a negative impact. Well we have exceeded that figure and while oil prices may fluctuate, the impact of high gas prices is, in my opinion, here to stay.

That consumer engine I referred to that conked out needs to be replaced. Just a couple of weeks ago we received confirmation that the consumer is finally realizing that he or she can do without that gas guzzler engine and SUV. The front pages of our newspapers announced that the big three American automobile manufacturers are substantially reducing, if not eliminating leasing as a means to finance the automobiles and trucks they sell. They blame the losses they are taking on the sudden drop in residual values due to high oil prices. Give me a break! While there is no question that oil prices have caused residuals to drop more than may have been projected, the automobile manufacturers have used subsidized leases as a marketing tool for years in large measure because of studies demonstrating high consumer satisfaction from leasing. That the US based finance companies and banks providing automobile lease financing may not be able to get the financing they need due to their creditworthiness, or lack thereof, may well have been the catalyst.

The bear market in stocks doesn't help either. Nicholas Perna, Economic Advisor to Webster Bank, reported that during the final quarter of last year and the first quarter of 2008, household net worth dropped more than \$2 trillion due to falling home values and declining equity share prices. Employment also has been increasingly negative. Unemployment is up and this further affects consumers' ability to spend or pay down debt. In sum, these factors combine to represent a brake, as is stopping the vehicle of consumer spending. And with the Government's rebate checks now having been spent and retail sales down in real terms, a quick U turn in consumer spending is unlikely.

Now let's turn to the Commercial side of the economy. The white swans have returned and we are now experiencing a return to the normal progression of smaller companies, more vulnerable to a downward economy than upper market companies, being the first to experience more defaults, prepackaged bankruptcy plans, bankruptcies and liquidations. The IMF says that while financial institutions have raised substantial new capital, globally they have written off about \$400 billion since last August, and, that these losses have "exceeded capital raised." Thus it is not rocket science to say there will be less new bank money for commercial borrowers, period. Distressed companies will have a more difficult time and it is unlikely that banks will be chasing bankrupt companies, if they aren't already a part of a company's capital structure before the bankruptcy. To give you some perspective, Lisa Lee in the Deal magazine just reported that research firm Dealogic calculated that US debt refinancings, for both distressed and

healthy companies plunged 80% in the first half of 2008 to \$67 billion from \$338 billion one year ago.

The IMF reaffirmed its projection of credit losses approaching \$1 trillion, yes, that's trillion with a T. Tom Romero, Managing Partner and founder of Capital Research Partners in Westport CT in an article he titled "Dealing with the Coming Commercial Credit Crisis" referred to a Goldman Sachs report released in March that predicted global credit losses reaching \$1.2 trillion, with Wall Street accounting for nearly 40%. The report said U.S. leveraged institutions, which include banks, broker-dealers, hedge funds and government sponsored enterprises, would suffer more than \$500 billion in credit losses after loan loss provisions. Professor Roubini, in his Barron's interview, has projected credit losses "most likely closer to \$2 trillion".

Reflecting both losses and lack of capital, banks and other lenders now are tightening their credit standards for all types of loans. Sound familiar? And, with the prodding of regulators, a new found conservatism is emerging that really represents a return to old fashioned commercial banking. This translates to looking at the underlying assets supporting the loan and providing for covenants. Forgive me for a shameless commercial, but Webster Business Credit, as an asset based lender continues to follow the same criteria it has for years, with money to lend based on established formulas providing for advances based on a company's accounts receivable and inventory. We also look for debt service coverage, that is, the company needs to have the cash flow to pay its interest expense and debt obligations as they come due. This may sound over simplified, but I see so many financial packages, even with underlying assets, where the company has so gorged itself on debt that it is unable to pay back what it has borrowed. The deleveraging of Corporate America must take place.

Whether we are talking \$1 or 2 trillion in additional losses, the message is clear to me that it will take some time to deleverage, absorb losses, stabilize supply and demand and regain the confidence to support growth again. The use of the term Recession is, in my view academic, as we all know that the National Bureau of Economic Research declares a recession after the fact. The central theme I want to leave you with today is that we have a tough ride ahead, one that will last for a few years.

► Impact of Deferred Write Downs and Fair Value Accounting

As I am addressing an audience of CPA's, I would be remiss if I didn't refer to the impact of deferred write downs and my views on Fair Value Accounting. Throughout my career as an asset based lender, both in a finance company borrowing from banks and now as a banker lending to companies, it has been standard banking practice to write off or fully reserve against a receivable that is 90 days past due. However recently, I have read of banks that have moved the 90 day rule to 120 days, possibly with the encouragement of government officials asking these banks to work with borrowers rather than move to foreclose on their property. The implication confirms to me the point that we continue to defer reporting losses.

As to Fair Value Accounting, having graduated with a degree in public accounting, it was drilled into me that when an asset's value is impaired it needs to be written down.

No argument. But, I question the logic to report as income the difference between the reduced value of a debt by a debtor experiencing financial difficulty without cash reserves, because the debt is now valued less than the obligation due.

Thank you for the opportunity to express my views on the current credit predicament. I will be happy to answer any questions, which you may have.